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January 14, 1997

EX PARTE

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, DC 20554

Re: CC Docket No. 96-98

Dear Mr. Caton:

On Tuesday, January 14, 1997, the attached letter was sent by Fedex to each of the FCC Commissioners.

Two (2) copies of this Notice are being filed with the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Sincerely,

Martha H. Ullberg

Martha H. Ullberg
for Alfred E. Kahn

Attachment

cc: Chairman Hundt
Commissioner Chong
Commissioner Ness
Commissioner Quello

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January 14, 1997

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, N.W. - Room 814
Washington, DC 20554

Dear Mr. Chairman:

I have studied the letter of December 2nd by five former Department of Justice economists declaring their support for the FCC's conclusion that charges for network elements and interconnection should be "based on total element long run incremental cost (TELRIC)." Aside from their unexceptionable statement of the general principle that "prices based on forward-looking costs give the right signals to both producers and customers to ensure the efficient use of resources," I find myself in fundamental disagreement with them, for the following reasons.

I. Which TELRIC—blank slate or actual? The declaration is totally silent on the issue—intensely contested at both the Federal Communications Commission and in arbitrations all over the country—of whether the "basis" for these charges that they endorse is to be the (estimated) incremental costs that will actually be incurred by the LECs or, instead, the estimated costs of a hypothetical, completely new network, employing the most efficient current technology and constructed from the ground up. Since AT&T, the sponsor of their statement, and the FCC have each supported versions of the latter, "blank slate" version of TELRIC and the authors write in explicit support of the FCC's position, their intention is, presumably, to support that version, even though they nowhere explicitly do so. And they nowhere explicitly defend that version against the criticisms from a number of sources.

The general economic principle that they cite clearly requires, however, that the correct pricing "signals" inform consumers of the costs that society will actually incur if they take somewhat (or a lot) more of each good or service—or that society will save if they take less. These can only be the actual incremental costs of the incumbent companies.

Advocates of the "blank slate" version of TELRIC typically assume that that is the level to which competition would drive prices, if it were effective. They are mistaken. In a world of continuous technological progress, it would be irrational for firms constantly to update their facilities in order completely to incorporate today's lowest-cost technology, as though starting from scratch: investments made today, totally embodying today's most modern technology, would instantaneously be outdated tomorrow and, in consequence, never earn a return sufficient to justify the investments in the first place. For this reason, as Professor William J. Fellner pointed out many years ago, firms even in competitive industries would systematically practice what he calls "anticipatory retardation," adopting the most modern technology only when the progressively declining real costs had fallen sufficiently below currently prevailing prices as to offer them a reasonable expectation of earning a return on those investments over their entire economic life. In consequence, even perfectly competitive prices would not be set at the level of these (totally) current costs.

The Commission justifies this same version of cost on the ground that the actual costs of the incumbent companies may reflect inefficiencies of their present operations, which clearly suggests it expects the costs of its preferred version would be lower than actual costs. The LECs' objection to that version clearly reflects the same understanding. And in point of fact, the results of Hatfield models presented typically by the IXCs in arbitration proceedings do generally run much lower than the LECs' estimates of their own incremental costs.

In either event, the Commission's prescription reflects a presumption all too typical of regulators—declaring, in effect, "we will determine not what your costs are but what they ought to be." That approach has two major defects: first, that is not how the competitive process works; and second, its prices would actually discourage competitors coming in and building their own facilities when that would be more efficient than using the incumbent's facilities—which it was the clear intention of the new Act to encourage.

In unregulated markets, prices tend to be set on the basis of the actual costs of incumbent firms. That gives challengers the proper target at which to shoot, the proper standard to meet or beat and the proper reward if they succeed. If they can achieve costs lower than that, they will enter and in the process (which the FCC's pricing rules would short circuit) beat prices down to efficient levels. Ultimately, only the market, and not regulators, can determine the efficient result.

II. The ignored question of required markups above incremental costs. The FCC recognized that rates set at bare incremental costs would not produce enough revenue for companies to recover even their total forward-looking costs, let alone the costs that they have incurred historically and not yet fully recovered, along with the revenue deficiencies created by the underpricing of basic residential service. The critical issues therefore revolve around the markups above incremental costs that may be incorporated in these charges to competitors—in compliance with the Act's provision entitling the LECs to an opportunity to a "reasonable profit." The clear intention of the insistence by the five economists that prices be based exclusively on forward-looking costs is, of course, to foreclose a markup above incremental costs in order to permit recovery of any portion of the huge sunk costs that the incumbent LECs have incurred in constructing their ubiquitous networks. Only prices based exclusively on forward-looking costs would be, as they put it, "fair" and "reasonable."

It is not clear what qualifications they have for defining that "fairness" and "reasonableness." The FCC is dealing here with companies that have for scores of years been regulated as public utilities, and continue to be. Fairness and reasonableness can logically be defined only in terms of the context of that historical and continuing regulation; it should not be based solely on the general economic principle they cite.

Over the decades, regulators have made all sorts of promises to the utility companies, as a means of holding down prices. For example, when new subscribers were hooked up to receive service, the major part of the (non-recurring) costs were not charged to them but capitalized—with a promise of return on and of the undepreciated balance over the future. And regulators of telephone companies have substantially underpriced basic local exchange service, permitting the companies to make up the discrepancy by correspondingly overpricing discretionary "vertical" services and toll services, and after the AT&T divestiture correspondingly set access charges to the long-distance carriers at levels designed to continue the requisite subsidy flow.

By the standards under which I as a regulator was constrained to live, "fair and reasonable" rates were ones that gave the companies a reasonable opportunity to recover those actually incurred costs, including the costs of underpriced basic residential dial tone.

That history has an additional implication for the attempt of the FCC, with the approval of these economists, to dictate a basis for the setting of these rates that excludes recovery of those costs. In all of the regulatory practices that I have described—and especially in the underpricing of residential dial tone—there have been wide variations from state to state and from region to region within states. There is simply no way a Federal agency can determine the extent of those individual obligations or reach equitable settlements, company by company, in the transition to full competition.

III. The <u>prerequisites of innovation</u>. While stressing the dynamic changes in telecommunications and the importance of a favorable climate for innovation, the five economists support a specific prescription for pricing network elements and services that is entirely <u>static</u>. Any proposal that rates be set at costs, or cost plus regulatorily-prescribed markups, should at least, in consideration of the importance of encouraging innovation, distinguish the rules applicable to providing existing network elements from the rules that would apply for supplying innovative new ones. To tie the rates for new services closely to costs, incremental or otherwise, would fatally attenuate the incentives of both incumbents to develop new and innovative service and of competitors to enter on a facilities basis. The rule that these economists support for the pricing of network elements, along with the FCC's pricing rules for services purchased for resale, clearly discourage that most creative form of competition.

The historical institution of tightly regulated, franchised monopolies lacked competitive stimuli to innovation. But in offering those monopolists reasonable assurances that they would be permitted to recover their total prudently incurred investment costs—of unsuccessful as well as successful ventures—it did have a positive effect on their willingness and ability to innovate. As we have moved from cost-plus regulation to a competitive system, however, any requirement that charges to competitors for innovative new network elements be closely tied to some narrow measure of cost would destroy that previous symmetry. Rival entrants would then have the option of purchasing the results of successful innovation at bare cost, while leaving stranded the costs of unsuccessful ventures. The system would be one in which investors would be forced to absorb the costs of failed ventures—as in competitive markets generally—but be denied the offsetting opportunity, essential to innovation in a competitive system, to reap whatever rewards the unregulated market will provide for the ventures that turn out successfully.

In short, TELRIC—whether the actual or the hypothetical, blank-slate version—is the wrong pricing standard to use for a competitive industry, from the vital standpoint of encouraging innovation. Presumably, the IXCs and their economists agree, since they simultaneously have asserted that the long distance business is fully competitive and that it is reasonable for them to charge rates several times their own incremental costs.

IV. The prerequisites of efficient competition. Finally, there is the clear implication in the letter (see pars. 4 and 5) that charges based on actual LEC costs, and particularly if they incorporate markups to recover any portion of historical costs, would be "anti-competitive"—which can only mean that they would deny equally efficient rivals an opportunity to compete with the incumbents. This contention is surprising for three reasons:

1. One of the authors is a founding father of the efficient component pricing rule, the essence of which is that so long as the charges by incumbents to competitors for use of their essential facilities are fully reflected in (or "imputed" to) the incumbents' own retail charges, efficient competition is in no way jeopardized—provided those retail charges of the LECs fully recover their own LRICs as well. Of course, application of this rule does not apply where retail prices are set below costs to meet regulatory requirements.

2. In any event, presumably all of these economists know about the historic antitrust case in which the Aluminum Company of America was found guilty of imposing an illegal squeeze on competing fabricators. The Court made this finding not on the basis of the absolute level of Alcoa's charges for ingot—the essential input in that case—but on the margin between that ingot price and Alcoa's own charges for the fabricated products: it was the failure of that margin to recover Alcoa's incremental fabricating costs that was the basis for its condemnation. Nowhere does the Alcoa doctrine even remotely imply that the height of the ingot charge itself had any relevance to the charge of monopolization.

3. The 1996 Act itself recognizes this principle. It requires Bell companies that have been authorized to provide in-region long distance services to charge their own long

distance operations the same rates for exchange access that they charge to others. This simple measure ensures that the absolute level of exchange access rates will not influence the competitive outcome.

What we need, therefore, are the Act's instructions to the states to open their systems to competition, removing all barriers to entry and giving competitors access to essential facilities, at rates set at "just and reasonable" levels—which means incorporating in those rates whatever portion of the actual costs of the companies and whatever markups their respective traditional regulatory practices justify—at the same time requiring compliance by the LECs with the Alcoa rule.

Sincerely,

Alfred E. Kahn

Alfred E. Kahn

AEK:mhu

cc: Commissioner Chong
Commissioner Ness
Commissioner Quello